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FORM OVER SUBSTANCE: FIVE STEPS TO MEANINGFUL TAX REFORM IN INDIANA WITHOUT OVERHAULING THE SYSTEM

By Donna Niesen, CPA

When experts debate tax reform or tax simplification, the discussion typically centers on ways to reduce or redistribute the quantifiable dollars and cents that taxpayers incur. Countless examples exist: flat taxes, the elimination or reduction of one set of taxes for the expansion or creation of another set of taxes, and so on. Proposals for these scenarios often require a complex reworking of the very foundation of state and local tax policies, impacting how these taxes and fees interact with one another at every level of government.

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The issues surrounding these sorts of debates are substantive, far-reaching and important. And they can require an almost seismic shift in the ebb and flow of taxes. The result, if properly executed, can be transformative but slow, if not unlikely, to enact.

Lost in these often divisive efforts are the changes that can be implemented in the everyday reporting, paying, collecting and enforcement of state and local taxes, an area generally referred to as tax compliance. While these sorts of changes will not make headlines in financial periodicals or dominate editorial pages, their impact on taxpayers and public tax officials can be equally – if not more – impactful than tax reform, and they are easier to enact without the same threat of controversy or resistance.

Outlined below are several such options that, if implemented, would constitute significant strides towards the goal of tax simplification in Indiana.

1. Overhaul Nonresident Withholding Reporting

Indiana law requires all pass through entities (PTEs), including S corporations, partnerships and LLCs, to withhold Indiana income tax on behalf of their nonresident shareholders, partners or members (nonresident shareholders). Additionally, certain nonresident shareholders are required to be included in a composite return filed by the PTE. While many states require nonresident withholding and/or composite filings by PTEs, the way in which Indiana has chosen to implement its requirements is particularly burdensome in comparison.

From a filing standpoint, there is a heavy burden placed on PTEs to correctly comply with the various withholding and composite return filing requirements. Additionally, the complexity of the filing requirements places a heavy burden on the Department of Revenue to correctly process returns and payments. If done incorrectly, reporting or processing errors can result in notices and the imposition of penalties and interest on the PTE, and an overall hassle for both sides to resolve.

The following are examples of the complexity that results from Indiana's current policy:

- *PTE has one resident individual shareholder, two nonresident individual shareholders, and one shareholder that is a nonresident PTE (upper tier).* PTE has a responsibility to withhold and remit payments on behalf of the two nonresident individual shareholders and the upper tier. The two nonresident individual shareholders are also required to participate in a composite return as they have not filed opt-out forms with the PTE.
    - PTE has a requirement to do the following: 1) Remit a payment on behalf of the upper tier by e-filing forms WH-1, WH-3 and WH-18 via INTax and make an electronic payment for the upper tier's tax due via INTax; 2) submit withholding on behalf of the two nonresident individuals by filing form IN-COMP (or IT-6WTH if extending) and issue a paper check to the department. In this scenario, the PTE has to file eight documents to comply with the Indiana rules (IT-65, IN-COMP, IN-K-1, WH-1, WH-3, WH-18, one paper check and one e-payment), six of which are directly related to the mandatory withholding and composite requirements. Additionally, PTE has to file some items online and other items in paper format in order to fully comply. For federal purposes, the PTE has two items to file (1065 and K-1).
    - To provide a contrasting example with a simpler jurisdiction and the same set of facts, the PTE would have a requirement to do the following in Alabama: File Forms 65, AL K-1 and PTE-C and a payment voucher, and make payment with form PTE-C for composite tax paid.

Alabama's filings are substantially less burdensome than Indiana's while achieving the same result: payment of tax on behalf of the nonresidents via the entity operating in-state. Additionally, the calculations and payment occur in one place/on one form and are submitted together regardless of type of shareholder. The PTE would not have to file some information on paper and other information electronically in order to comply. (Note: Alabama does not impose a withholding requirement. Rather, it requires the PTE to file a composite return on behalf of all shareholders. Information related to the composite payment is reported to the shareholder on its AL K-1, and the shareholders use the K-1 as proof of the tax paid on their behalf when filing their own returns.)

SOLUTION

Solution: The fact that Indiana's non-resident withholding rules have plagued taxpayers for many years signals that an easy and effective solution has been challenging to achieve. That said, a simple and effective remedy to simplify nonresident reporting would be for Indiana to implement the following complement of changes:

- Repeal nonresident withholding.
- Create a requirement for participation in composite returns for all nonresident shareholders (including other entities).
- Continue to allow the nonresident shareholders to file returns and take credit for the composite payments made on their behalf.
- Develop a process to utilize the Indiana K-1 as the sole proof of composite tax payment.

By following the lead of states such as Alabama in utilizing a composite return approach only, and by treating all nonresident shareholders the same with regard to making payments on their behalf, Indiana could significantly decrease the compliance burden on PTEs, as well as reduce the departmental internal burden on review and processing of the many returns associated with nonresident withholding.

2. Simplify the Sales Tax Rules for Real Property Construction Contractors

One of the most frustrating areas of sales tax compliance, both for taxpayers and state auditors, involves construction contracts. The reasons are numerous.

First, the rules can vary greatly from state to state. Due to lack of internal resources, some companies will apply a one-size-fits-all approach to compliance mindful of the fact that errors from state to state will result.

Second, given the frequent use of subcontractors, companies do not control all of the paperwork associated with each job. As a result, in the event of an audit, it is extremely difficult to produce all of the pertinent documents related to the jobs that an auditor examines.

Third, the free-flowing use of exemption certificates and direct pay permits inevitably results in these documents being issued improperly. Lastly, given the sheer complexity and size of some jobs, the chore of ensuring good sales tax compliance is simply overwhelming at times.

Of course, one or more of these factors can conspire over the course of multiple jobs to create additional reporting issues. Some of these factors are intrinsic to the industry and therefore cannot be solved by new laws or regulations. However, Indiana could implement one simple change to cut down on the needlessly maze-like structure of its current sales tax system for contractors.

By way of background, current taxation of real property construction contractors is dependent on the type of contract entered into with the customer. For a contractor that utilizes multiple types of contracts, this practice creates a significant compliance burden that, if done incorrectly, can eat into a company's profits.

The current rules are as follows:

1. *Lump Sum Contracts*: Contractors entering into lump sum contracts are deemed the end user of all materials incorporated into the real property of the customer. As such, the contractor pays sales tax on the materials it purchases; the tax is on the contractor's cost. When invoicing the customer on a lump sum basis, no sales tax is collected from the customer.

2. *Time & Materials ("T&M") Contracts*: Contractors entering into T&M contracts are treated as retailers. Therefore, they purchase all materials exempt from sales tax. When a contractor invoices the customer on a T&M basis, it collects sales tax on the materials. The sales tax is collected on the marked up price charged by the contractor for the materials.

Using two different methods creates a significant compliance burden for the contractor. The contractor has to analyze every purchase to determine which type of contract the purchase relates to, and then the contractor has to ensure that the sales tax treatment applied to every purchase is correct based on that contract classification. Not only do the CFO and/or controller have to understand the sales tax rules, but every AP clerk and processing employee has to have command of the sales tax rules for contractors to ensure the proper treatment after a purchase is made.

It also creates a significant upfront burden on the contractor to ensure that the estimator providing a quote to the customer has a strong understanding of the sales tax rules. The estimator has to take into account the sales tax costs in order to achieve the desired profitability. If the estimator misunderstands the sales tax rules, an unnecessary 7% sales tax hit can drag a profitable job into a loss.

In addition to the complexity related to understanding the two sets of rules, contractors often grapple with which type of contract they are utilizing. The sales tax regulation only contemplates lump sum or T&M contracts. However, many contracts do not fall squarely in either bucket. Examples include T&M contracts with "not to exceed" language; contracts from construction managers utilizing nothing but subcontractors; "cost plus" contracts (including "cost plus fixed percentage" contracts or "cost plus fixed fee" contracts). In many instances, a contractor is uncertain of which sales tax rule it should apply to a particular contract type. If the contractor takes the position that a contract is lump sum but an auditor determines that the contract is T&M, the additional tax owed can have a significant impact on the contractor's business.

Solution: The simplest and fairest solution to simplify sales tax compliance for contractors would be to level the playing field for all contractors: tax all contracts the same, regardless of their type (lump sum vs. T&M). Indiana is in the minority of states that treat contractors differently depending on the contract type entered into with the customer. Most states treat contractors as the end user of materials in all cases; therefore, regardless of the type of contract entered into, the tax is imposed at the time of the contractor's purchase of tangible personal property. Treating all contractors as the end users of materials regardless of the type of contract would greatly ease the overall compliance burden of construction contractors. This change would create a lesser compliance burden for contractors, and an easier profile of transactions to examine for sales tax auditors.

SOLUTION

3. Repeal the Throwback Rule

Typically, when determining a company's sales apportionment for income tax purposes, the sales factor is based on where a product is shipped. So, if a company sells widgets and ships the widgets to an Indiana location, those sales are captured in the numerator of the Indiana sales factor.

States that employ a throwback rule require sellers of goods to take an added step in computing their percentage of apportioned sales: if the seller has not created income tax nexus in the destination state of a particular sale, that sale is "thrown back" to the origin state.

The proportion of sales to a company's total apportionment varies from jurisdiction to jurisdiction, with some states including other apportionment factors such as property or payroll. In states where sales make up the lone apportionment factor in order to create a tax based on the company's business markets and not operational capital, the throwback rule frustrates if not fully undermines this objective. The throwback rule places more emphasis on where the product was created, or the point from which it is distributed, rather than the place in which it will be used. When coupled with a single sales factor regime, the throwback rule indirectly taxes inventory once located in the state. In essence, it becomes a disguised personal property tax.

The throwback rule directly impacts Indiana-based manufacturers or out-of-state companies with large Indiana manufacturing or distribution operations. It also indirectly negatively impacts the transportation and logistics community that Indiana is known to cultivate and support. Out-of-state companies may refuse to utilize Indiana-based distribution points because having their inventory in Indiana may significantly increase their Indiana tax burden, even inventory that is distributed to a location outside of Indiana.

SOLUTION

Solution: The solution is simple with regard to the throwback rule: eliminate it. Indiana is one of a decreasing number of states utilizing a throwback rule in conjunction with a single sales factor apportionment method in the first place. In fact, a mere 50% of states still impose a throwback rule, and only eight states with single sales factor apportionment utilize the throwback rule. Eliminating the rule will solve that problem.

In addition, removing the throwback rule will better align Indiana with its positive attributes as a destination for manufacturing, transportation, warehouse, and distribution companies. The throwback rule has been a red flag for site selection consultants as long as it has existed. It is past time for the rule to be repealed.

4. Create a Bureaucracy Czar

Every year, the Department of Revenue issues thousands of notices and assessments. In some instances, the taxpayer receiving the notice must take immediate action or be restricted from carrying out certain business within the state. These notices can take many forms: a retail merchant that is not in good standing can have its license restricted; or, a car dealership with an outstanding tax notice can have its ability to do business with the Bureau of Motor Vehicles suspended. In such instances, these stoppages to a taxpayer's business are crippling.

Of course, not every departmental notice must rise to the level of business stoppage to cause an adverse effect on a taxpayer. Simple notices may come with an inadequate explanation about their source and no point of contact within the Department to answer questions about the notice and resolve the matter quickly.

The following examples demonstrate both varieties of problems: those notices rising to the level of business stoppage, and simple issues that can be quickly resolved when routed to a knowledgeable representative.

In the first example, a car dealer submits its monthly payment for sales tax collected but fails to e-file its form (the calculation of the sales tax amount due). The car dealer receives a notice showing a "best information available" liability amount because it has not submitted the form, even though the tax has been paid. That outstanding liability information is shared with the Bureau of Motor Vehicles (BMV). When the car dealer sells a car in an unrelated transaction and tries to submit the titling paperwork, the BMV informs the dealer that the paperwork cannot be filed because there is an outstanding sales tax liability on its account.

In this instance, the car dealer is handcuffed from a business perspective until this issue is resolved. Currently, the car dealer would have to submit the form and try to locate an advocate within or outside state government to expedite its processing. Then, the dealer would have to wait until the account is updated, at which time the updated information could be shared with the BMV before the dealer is able to process the title paperwork. This final point may go without saying, but the real-time of these events can cover a period of hours or days if no one within state government is able to act with authority, or with a sense of urgency, to resolve the matter.

Another example, with less drastic but still meddlesome consequences, involves a company that goes out of business or is part of a restructuring, and thus has no operations. The company fails to close its sales tax account; thus, it has outstanding liabilities issued against it. A new entity owned by the same individuals applies for a liquor license and is denied because of the outstanding sales tax liabilities of the closed business. While all the closed business has to do is file a single piece of paper showing that it is closed and owes no tax to resolve the issue, the time it takes for the form to be processed, updated in the government's system, and shared with the processing agency delays the license being issued.

This prelude to avoidable bureaucratic snafus is not intended to suggest that all taxpayers are without fault when receiving these notices. Regardless, three critical points must be made. One, a taxpayer faced with the prospect of its operations being suspended must be provided with an immediate remedy. Two, when the department threatens to take the coercive action of suspending a company's business, the taxpayer's alleged error must be commensurate with a penalty so debilitating. Third, when the department issues a notice to a taxpayer requiring payment or some corrective action, that taxpayer needs to be provided with a resource that can provide a quick resolution to its issue.

The quick term solutions to these problems are easy to provide. First, the department must provide an avenue for a taxpayer to interact quickly with a knowledgeable representative.

Second, the department needs to establish benchmarks for proposed assessments or other infractions that constitute an act of omission or commission whereby the punishment fits the crime. For example, currently, any assessment of any amount, once it reaches a certain age, can result in a suspension of a company's ability to receive licenses, clearances, or other forms of permission needed to conduct business with state agencies. In many instances, such notices can result in the issuance of a sheriff's warrant if the infraction remains unresolved. A sheriff's warrant can result in the incurrence of additional fees and a black mark on the company's credit report, even if the "crime" was not filing a single sheet of paper.

For companies that rely on the uninterrupted flow of activity between private industry and its state and local government for licenses, good standing, and the like so that they can operate their businesses, suspensions can serve as financial death penalties. Such stoppages should be a rare, rare exception, not the rule.

Solution: To evaluate and facilitate the expeditious resolution of these situations, the department could create what might be called a Bureaucracy Czar. This position and its staff would serve as a single point of contact to categorize those notices that fall outside the category of garden variety, taxpayer services level of questions. For example, if a taxpayer correctly calls the number listed on a tax notice and the division it reaches is unable to understand and resolve the taxpayer's issues, the issue will be transferred to a Bureaucracy Czar representative.

Additionally, those calls that are the result of the department acting to suspend the company's ability to do business with a state agency will also fall within the jurisdiction of the Bureaucracy Czar.

Isolating these issues in this way will provide three important benefits. First, it will ensure that such issues are addressed with a sense of urgency, and assistance will be provided until the resolution is reached. Second, the exigent nature of the calls routed to this group will require the employees in the division to become well-versed in common problems and easy solutions. Third, by seeing these recurring problems on a consistent basis, the Bureaucracy Czar will be best equipped to suggest long-term solutions to the problems as they arise and recur.

SOLUTION

5. Remove the Double Direct Test for Manufacturing Sales Tax Exemption

With over 8,000 manufacturers[1] located in Indiana, it is undisputed that Indiana falls squarely within manufacturing country. These Indiana manufacturers enjoy a moderate sales tax exemption for purchases used in an integrated production process, an exemption aimed at encouraging growth and preventing tax pyramiding.

This exemption employs what is called the double-direct test. This test, its name derived from case law, refers to the precept that in order for a purchase of tangible personal property to quality for the sales tax exemption afforded to manufacturers, the item must be directly used in the direct production of tangible personal property. Explained differently, both by commentators and still other court cases, the property in question must be essential and integral to the production process.

[1] U.S. Census Bureau shows 8,142 Indiana manufacturing establishments as of 2012.

As even a layperson might discern, the use of vague, arbitrary, and difficult-to-define terms such as "double-direct," "essential," and "integral" can result in the scattershot drawing of lines around which types of activities quality for the manufacturing exemption and which do not. Additionally, if items are purchased in bulk and used in both taxable and exempt ways throughout a plant, tracking taxable and exempt percentages for such purposes can be a time-consuming, non-value added activity.

The following exemplify the often arbitrary and arcane application of the double direct test:

- Safety items: It is generally understood that items used to protect a production worker from injury while that worker is engaged in the production process are exempt from sales tax. However, the question arises, what is injury? If an employee wears gloves to protect from chafing, does chafing rise to level of injury? Does the same concept apply to paper cuts? What about the uncomfortable but not dangerous irritation that a worker incurs when handling work-in-process with a borderline-hot temperature?

Apart from these wispy scenarios, still other absurdities play out in applying this test to safety items. For instance, gloves worn by a worker while engaged in a taxable activity, such as handling raw materials, or used for non-exempt reasons such as to keep their hands clean, are subject to tax. Maybe more confounding is the idea that protecting the worker is exempt (wearing flame-retardant clothes) but preventing or remediating the harm (fire alarms and extinguishers) is not. So, hair-splitting of this degree may preserve the double-direct test, but what broader tax policy is being served?

- Forklifts: Movement of work-in-process is considered to be part of the manufacturing process, thus meeting the double direct test. However, movement of raw materials or finished goods is a taxable activity, because even though such movement is directly part of the process, it is outside the confines of the double direct test. Thus, when considering equipment such as a forklift, the double-direct test can result in a partial exemption—a forklift being used in an exempt manner in some instances and taxably in others. Therefore, for the manufacturer to quality for the partial exemption, it must track the taxable and exempt use and subsequently be able to document the exempt percentage to an auditor. As alluded to above, do the ends justify the means in preserving the integrity of the double-direct framework?

- Repair Equipment: It is undisputed that a piece of equipment that acts on the raw materials meets the double direct test and qualifies for the manufacturing exemption. In addition, if that exempt equipment needs a replacement part, it is also exempt. However, if a drill, wrench, or hammer is needed to perform the actual repair of the exempt equipment, it is taxable. Again, what purpose does this serve?

SOLUTION

Solution: Create a single direct test. To craft this solution, Indiana could borrow from the enforcement of its exemption for taxpayers providing for-hire transportation services. In Indiana, purchases directly used in providing for-hire transportation services qualify for a sales tax exemption. This standard is known as the single direct test.

While this test may sound similarly vague to the double direct test, in practice it is easily enforced. The department, taxpayers, and the courts easily and freely recognize that any purchase by a transportation company, except for sales and marketing purposes, meets the single direct test and are therefore exempt from tax. By implementing such a concise rule with an explicit, simple bright line, almost all conceivable taxable-versus-exempt controversies would vanish.

While implementation of this new standard may have some adverse impact on tax revenues collected, it will also provide substantial savings, both for taxpayers that no longer need to dedicate resources to tracking exempt versus taxable purchases, and for state tax auditors and hearing officers who spend days and weeks poring through the detailed documentation related manufacturers.